KEYNOTE INTERVIEW

GP-led deals shift secondaries market dynamics

As supply outstrips demand, GP-leds can prove compelling for secondaries buyers with the right strategy, say Neuberger Berman's Tristram Perkins, global co-head of secondaries private equity; Frank Guglielmo, principal; and Victor Ko, principal

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Q What are you currently observing in terms of the supply of GP-led secondaries in 2022? What are the key drivers of activity?

Frank Guglielmo: The GP-led market continues to be extremely active. GPs are seeking to offer an attractive liquidity option to existing LPs while retaining ownership in high conviction assets to provide additional time to execute on the value creation plan. Historically, a GP's exit option was to sell a company to another sponsor, to a strategic buyer or to complete an IPO. Rather than exiting a high-performing asset, particularly through a sale to another sponsor, GPs can pursue a continuation fund to seek to maximize the value of the asset and capture additional upside.

In many cases, GP-led transactions have proven to be a win-win-win for GPs, LPs and secondaries buyers, which is driving continued growth. Not only are we seeing more GPs exploring continuation funds, but we are now seeing GPs that have completed successful GP-led transactions coming back to market with their second, third and fourth GP-led transaction.

Tristram Perkins: The GP-led transaction has become an established fourth alternative exit route for private assets and investment banks are building up their advisory capabilities to support sponsors on these deals. We think GP-leds will continue to drive a significant portion of secondaries deal volume.

Additionally, LPs are currently inundated with re-up requests from existing sponsor relationships. If GPs are fundraising again after 18 months (rather than three or four years, as was historically the case) then LPs haven't necessarily received the liquidity from prior commitments that they need to re-invest. GP-leds create an opportunity to generate liquidity for LPs earlier in the life of the fund without forcing GPs to sell prime assets, arguably prematurely.

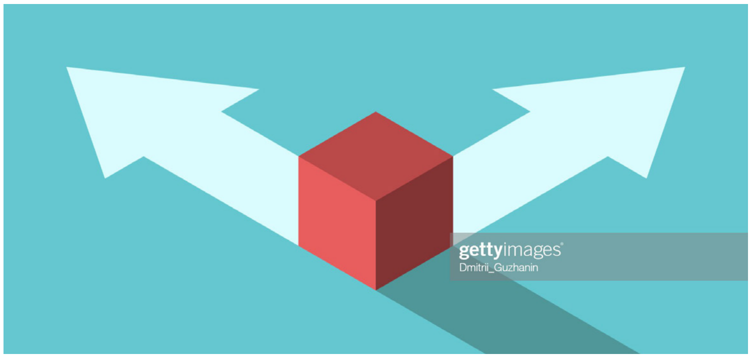
Q With GPs the biggest sellers in the secondaries market last year, how is that changing secondaries market dynamics?

TP: As more GPs and LPs adopt GP-led transactions as a duration and liquidity management tool, the GP-led market has more than quadrupled in volume over the last five years, accounting for more than half of all secondaries market transactions last year. We anticipate GP-led transactions could account for at least a quarter of all private equity exits and could reach $300 billion over time.

One aspect of GP-led transactions that secondaries investors look at to gauge the attractiveness of an opportunity is the exit alternatives for private companies. Companies that have another leg of near-term value creation, and therefore line up for sponsor-to-sponsor sales, are assets that make sense for GP-leds. Sponsor-to-sponsor sales have accounted for approximately 30-40 percent of private equity deal exits in recent years. If only half of those transactions convert to GP-leds instead, that can create a massive opportunity.

We see that secondaries markets are currently saturated with a supply of potential GP-led transactions and short on capital and experienced secondaries investors who have previously led and executed similar complex deals. There is a lot of demand from GPs, but GP-led activity is currently constrained by the amount of capital that a reasonably small number of secondaries groups have available to lead and underwrite transactions, creating interesting dynamics for buyers and secondaries investors with strong GP-led capabilities.

Reflecting the attractiveness of the opportunity, we are also seeing a number of new entrants try to build or acquire GP-led capabilities and raise capital around the opportunity. That being said, investing in GP-led transactions often requires a different set of skills and relationships.



Q How does the deal process differ between GP-led deals and LP secondaries?

FG: With a GP-led process, investors have more time and access to information, including direct access to the GP and management teams. GP-led transactions can take six to nine months. Investors can typically perform in-depth diligence on the companies and monitor performance to make sure they are performing in line with budget and the value creation plan implemented by the GP and management teams.

The other key difference is the lead investor's ability to negotiate and reset go-forward incentives with a GP to create a strong alignment of interest. Secondaries investors often structure a GP-led transaction with a tiered carried interest waterfall with both net IRR and multiple of capital hurdles. Through this alignment, a GP would only earn carried interest by meeting certain net return thresholds tied to the secondaries investor's purchase price.

VK: GP-led deals are usually more concentrated around a small number of companies, which means the secondaries investor needs to be able to do deep-dive diligence into those assets. That requires a lot of sector expertise and capital market knowledge, and the ability of an investor to tap into the resources of a broader platform, with dedicated sector specialists across private and public markets, is a key differentiator in unlocking the value in these complex transactions.

For secondaries managers who have historically focused on buying diversified portfolios of private funds, it is not easy to reengineer their approach to asset selection and underwriting in order to invest in more concentrated portfolios or individual companies. And while there are direct buyout managers who could potentially bring underwriting discipline to a GP-led transaction, it may be challenging to form partnerships with GPs with whom they may compete and gain access to attractive GP-led opportunities.

In order to lead a GP-led transaction, secondaries investors must have the ability to work with direct GPs as a value-add, trusted partner and the capability to underwrite, negotiate and structure these complex transactions.

Victor Ko: Despite the new entrants, we believe the GP-led market is still undercapitalized, particularly in mid-market continuation fund transactions, which often require more heavy lifting from the secondaries investor, in terms of both valuation of the assets and negotiation and structuring of the continuation vehicle. Mid-market GP-led transactions usually entail complex, long lead-time processes, not dissimilar to direct buyouts, which require the secondaries investor to independently diligence and price the risk of the private companies and negotiate engagement terms with the GP, including the GP's reinvestment, go-forward incentives and overall alignment with the secondaries lead. Also, mid-market GPs tend to be more selective and restrictive in term of whom they partner with on deals.

Q What should investors focus on when evaluating those deals?

FG: In addition to the usual financial metrics, valuation and capital structure, investors should focus on the alignment of interest with the GP, the GP's motivation in pursuing the transaction and their capabilities to create value in these specific companies and industries.

To create strong alignment, we believe it is important for buyers to structure continuation fund transactions as net investments for the GP, and not as a liquidity event. In addition to the GP rolling over their existing exposure to the assets into the continuation fund, investors should look to the GP to invest fresh capital personally into the transaction alongside the secondaries investor at the same purchase price.

VK: There are generally three key areas we believe investors should focus on when evaluating these complex investments. First, investors need to have the experience, resources and capabilities to independently and thoroughly assess the quality and value of underlying private companies. Second, investors need to build a strong conviction around the value creation thesis and the GP's ability to execute. Lastly, these transactions involve numerous different groups with different interests, so investors need to marry up all of those interests with the right structure, terms and governance.

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FRANK GUGLIELMO

Q What additional risks are associated with GP-led transactions, and how might those be mitigated?

TP: One risk that investors have focused on, relative to traditional LP secondaries, is the fact that these GP-led transactions tend to be large, because they offer a comprehensive liquidity option to the entire LP base, and more concentrated in a smaller number of private companies.

In our view, this risk is mitigated by the secondaries investor's ability to be selective in the specific private companies into which they are investing. In addition, the extended timeline and enhanced access to information that can occur with a GP-led process typically creates the opportunity to perform extensive due diligence, more akin to a direct buyout, on a select group of private companies. Investors can more actively manage exposure and create a diversified portfolio by focusing on fewer, more select assets.

VK: The objective of these deals is to reset the clock and extend the timeline for additional value creation, which means the cashflow profile could be a little different than for an investor in a portfolio of LP deals. That makes it important to have a disciplined approach to portfolio construction, to create a diversified stream of cashflows and vintages, and to consider single asset versus multi-asset deals.

TP: One emerging risk we are starting to see is certain secondaries investors using leverage in GP-led transactions. Our view is that there is plenty of leverage at the underlying company level and so adding that additional leverage creates a very different risk profile for investors.

Q Finally, what are your predictions for the appetite for GP-leds, and for secondaries activity more generally?

VK: Overall we think the secondaries market will continue to see strong growth. Historically only a small proportion of private equity assets have been traded on the secondaries market, and with trillions of dollars of unrealized value in private equity portfolios, we believe the opportunity set for experienced secondaries investors continues to be tremendous, and we expect GP-leds to be the fastest growing segment.

TP: The harder market dynamic to predict is pricing. From a secondaries buyer's perspective, the same dynamics that generated record primary fundraising over the past decade, namely record liquidity and investor net inflows combined with low rates, can create headwinds, making it hard to convince LPs to sell a quality asset at a discount to fair value. Looking at the market today, in light of increased volatility, a general tightening of liquidity and extension in the durations in private equity, it appears that the secondaries market could be entering into a more interesting pricing environment. ■